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IN THE

Supreme Court of the United States

OCTOBER TERM, 1939.

No. 559.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,
v.
JULIAN PRICE.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

DAVID H. BLAIR,
C. R. WHARTON,
GEORGE D. BRABSON,
Attorneys for Respondent,
Transportation Building,
Washington, D. C.

Of Counsel
JULIUS C. SMITH,
J. G. KÖRNER, JR.

BATAVIA TIMES, LAW PRINTERS,
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CHARLES W. WARD, N. WASHINGTON REPRESENTATIVE
TOWER BUILDING

SUBJECT INDEX.

	Page
Opinions Below	1
Question Presented	1
Statute and Regulations Involved	2
Statement of Facts	3
Summary of Argument	6
Argument	7
Point 1. Eckert v. Burnet arose out of an entirely different state of facts, and is distinguishable upon its facts from the case at bar	7
Point 2. Eckert v. Burnet did not involve the same issues of law as are involved in the instant case	9
Point 3. But even if Eckert v. Burnet is to be considered as correctly stating the rule as to the deduction of losses, the taxpayer here complied with that rule in all respects, and is entitled to deduct his loss	11
Point 4. The decision of the Court below has nothing whatever to do with obliterating the distinction between the cash basis and the accrual basis of accounting	39

Table of Cases Cited.

A. D. Weiss, 13 B. T. A. 1284	11, 24, 27, 42
A. W. Wolfson, 1 B. T. A. 538	13, 35
Avery v. Commissioner, 22 F. (2d) 6	14, 30
Allen v. Commissioner, (4th Cir.) ... F. (2d) ...	38
Burns Mfg. Co. v. Com., 59 F. (2) 504	10
Bailey v. Commissioner, (5th Cir.) 103 F. (2d) 448	11
Bedell vs. Commissioner, 30 F. (2d) 622	12, 19
Brinkerhoff-Faris Trust Co., 14 B. T. A. 801	12
Bank v. Hall, 174 N. C. 479	22

PAGE

Burnet v. Logan, 282 U. S. 404 35
C. W. Slater, 5 B. T. A. 804 13
Crain v. Commissioner, 75 F. (2d) 962 ..... 14, 23, 24
Consolidated Tea Co. v. Bowers, 19 F. (2d) 382 20
Clarendon County v. Curtis, 46 F. (2d) 888 22
C. R. Johnson, 8 B. T. A. 992 35
Commissioner v. John Thatcher & Son, 76 F. (2d) 900 ..... 36, 37
Dexter v. Com., 99 F. (2) 769 10
Darling v. Commissioner, 49 F. (2d) 111 ..... 14, 30
Dewey v. Bell, 5 Allen (Mass.) 165 22
Dyer v. Bray, 208 N. C. 348 22
Eckert v. Burnet, (1931), 283 U. S. 140 ..... 6, 7, 8, 9, 10, 11, 19, 25, 42
Ewing Thomas Converting Co. v. McCaughan, 43 F. (2d) 503 20
First National Bank, Executors v. Commissioner, (6th Cir.), .. F. (2d) 38
Ferris v. Commissioner, 102 F. (2d) 985 39
George J. Mellinger v. United States, 21 F. Supp. 964 .. 18
Humphrey v. Commissioner, 91 F. (2d) 155 .... 11, 19, 23, 30
Humphrey v. Commissioner, 91 F. (2d) 155 (9th Cir.) . 19, 30
Horne v. Young, 40 Ga. 193 22
Helvering v. Lazarus (December 4, 1939) 26
Insurance Finance Co. v. Commissioner, 84 F. (2d) 382 11
In Re Dixon, 13 Fed. 109 22
Jarvis v. Heiner, 39 F. (2d) 361 ..... 11, 23
Jenkins v. Smith, 21 F. Supp. 433, affirmed 99 F. (2d) 827 (2nd Cir.) 19, 23, 26, 34
John C. Hermann, 27 B. T. A. 409 ..... 28, 29
Jenkins v. Bitgood, 101 F. (2d) 17 39
Kilpatrick vs. Kilpatrick, 187 N. C. 523 22
Keenan v. Commissioner, 20 B. T. A. 498 29
Landers Bros. vs. Commissioner, 60 F. (2d) 85 11

PAGE

Lyle v. Olson, 24 B. T. A. 702 13
Mellinger v. United States, (Ct. Cl.), 21 F. Supp. 964.. 11
Mainard E. Crosby, 14 B. T. A. 980..... 13
Niagara Share Corp. v. Commissioner, 82 F. (2d) 208 36
Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U. S. 462 12
Potter Farms, Inc., 6 B. T. A. 110..... 13
Roberts v. Vonnegut, 58 Ind. App. 142, 103 N. E. 321.. 21
Rhodes v. Commissioner, 100 F. (2d) 966, 969..... 42
Shiman v. Commissioner, 69 F. (2d) 65.....7, 11, 42
Schlemmer v. United States, 94 F. (2d) 77..... 11
S. L. Meyer, 23 B. T. A. 1200..... 12
Schlemmer v. United States, 94 F. (2d) 77..... 17
Segrist v. Crabtree, 131 U. S. 287, 33 L. ed. 125..... 20
State v. Chambers, 179 Iowa 436, 161 N. W. 470..... 21
Squires v. Adams, 70 Ill. App. 502..... 22
Smith v. Bynum, 92 N. C. 108..... 22
S. E. Thomason, 33 B. T. A. 576 29
Smith v. Young, 11 Bush (Ky.) 393 34
Thatcher & Son, 30 B. T. A. 510 20
Terry v. Robins, 128 N. C. 140:..... 22
United States v. Collier, (C. C. A. 5), 104 F. (2d) 420. 11, 30
Wilford C. Saeger, 9 B. T. A. 890, 898..... 20
Yoder v. Nauts, 34 F. (2d) 450..... 14

OTHER AUTHORITIES.

Art. 321 Regs. 77, 74 .....13, 15
A. R. R. 113, C. B. 2, p. 114 14
A. R. R. 479, C. B. 5, 146..... 14
Art. 22, Regulations 69, 64, 62 and 45 15
Art. 23 (e) (1) Regulations 86 16
A. R. R. 2895, C. B. II-2, p. 233..... 35
48 C. J. Payment Sec. 41 34
46 Harvard Law Review 933 .....12, 35

PAGE

Holmes "Federal Taxes", sec. 471 ..... 12, 38
Harvard Law Review, Vol. 46, p. 936 13
I. T. 1182, C. B. I-1, p. 142 14
I. T. 1167, C. B. I-1, p. 149 14
I. T. 1697, C. B. II-1, p. 95 14
I. T. 1262, C. B. I-1, p. 71 35
O. D. 741, C. B. 3, p. 115 14
Paul & Mertens "Law of Federal Income Taxation" . 12, 37
Revenue Act of 1932, Sec. 23 (e), C. 209, 47 Stat. 169 . . 2, 10
Regulations 77, Art. 321 3
Revenue Act of 1926, Sec. 214 (a) (7) 10
Sec. 214 (5) 10
Regulations 45 under Revenue Act of 1918 13
21 R. C. L. Payment, Sec. 45, page 47..... 21
Sec. 72, page 72..... 21
Regulations 33, Art. 4 35

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BRIEF FOR THE RESPONDENT.

Opinions Below.

The memorandum opinion of the United States Board of Tax Appeals (R. 11-19) is not reported. The opinion of the Circuit Court of Appeals (R. 32-41) is reported in 106 F. (2d) 336.

Question Presented.

We can not agree that the Commissioner's brief correctly states the question before this Court. Actually there are two issues presented in this case.

The *first issue* is this: Will this Court undertake to review a *finding of fact* (not a conclusion of law) of the Board of Tax Appeals based upon evidence of record which was found sufficient by the Board, was undisturbed by the Circuit Court of Appeals, and which even the Commissioner does not now dispute as a fact—to wit, *Payment*.

The question as to whether or not the transaction here "constituted a payment of the original note", as stated in the Commissioner's brief, page 9, is *not* now an issue in this case. Payment was found as a *fact* by the Board of Tax Appeals. It was not a conclusion of law drawn as an inference or as a legal deduction from other facts. Payment was found *as a fact* by the Board, because the witnesses testified that the parties had expressly agreed upon a payment.

The *second issue* before this Court is this. *Payment* of the taxpayer's obligation under his guaranty contract with the Bank being conceded as a fact by the Commissioner (Brief, pp. 7, 12)—is the taxpayer here to be denied the loss which the Commissioner concedes has occurred (Brief, p. 10) merely because the payment agreed upon by the parties and accepted by the Bank was not made in the form of cash?

Statute and Regulations Involved.

Sec. 23(e), Revenue Act of 1932, c. 209, 47 Stat. 169:

> (e) *Losses by Individuals.*—Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business;

* * * * *

Regulations 77, Art. 321:

Items of *income* and of *expenditures* which as gross income and *deductions* are elements in the computation of net income *need not be in the form of cash.* It is sufficient that such items, if otherwise properly included in computation, *can be valued in terms of money* (Emphasis supplied.)

Statement of Facts.

The facts in the case were correctly found by the Board of Tax Appeals and have never been questioned. (R. 12-17.) The facts may be summarized as follows:

1. The taxpayer is a resident of Greensboro, North Carolina. During the year 1929 he was president and a substantial stockholder of the Jefferson Standard Life Insurance Company, which company was a large stockholder and depositor in the Atlantic Bank and Trust Company of Greensboro. The taxpayer himself was also a stockholder of the Atlantic Bank. (R. 12.)

2. In September, 1929, the Atlantic Bank was merged with several banks and trust companies under the name of North Carlonia Bank and Trust Company. Under the plan of merger certain assets of the Atlantic Bank, called "A" assets, were accepted conditionally by the North Carolina Bank and certain other assets, called "B" assets, were pledged to that bank with authority to charge against the "B" assets any losses which might be established in real-

izing upon the "A" assets. As part of the merger the taxpayer and three other stockholders of the Atlantic Bank executed a guaranty agreement to the effect that, if the North Carolina Bank failed to realize a certain sum from the "A" assets within two years, they would make up the deficiency in an amount not exceeding $500,000. The agreement provided that any sums realized from the "B" assets were to be applied first to any losses occurring in the "A" assets and then to reimbursement of the four guarantors. The period for realizing upon the "A" assets under the terms of the guaranty was subsequently extended with the consent of the guarantors for an additional year, or until September, 1932. (R. 12-13.)

3. In June, 1931, the North Carolina Bank advised the guarantors that their guaranty was not in such shape that the Bank could use it, and accordingly requested the guarantors to put their guaranty into a bankable form so it could be used by the Bank to obtain credit. Taxpayer agreed, and accordingly executed and delivered to the Bank a note for $125,000 and endorsed the note of C. W. Gold, another guarantor, for a like amount, and assigned certain securities to the Bank as security for the payment of his guaranty. In consideration of the taxpayer's doing these things, the Bank agreed that the taxpayer's ultimate liability under his guarantey should not exceed $250,000.

4. "At the end of 1931 the *Guaranty agreement was still in force and effect.* The 'B' assets were still in the hands of the North Carolina Bank as trustee and were still in the process of collection. No demand had ever been made upon the petitioner (taxpayer) for the payment of any part of his obligation under the guaranty. While it was known that there would be some loss to the guarantors, it was not

definitely known throughout 1931 what the loss would be, and the guarantors had every reason to believe that there would be a substantial reimbursement from the Class B assets of any losses." (Findings of Fact, Board of Tax Appeals) (R. 14-15).

5. In the early part of 1932 financial conditions in Greensboro took a turn for the worse, and collections on the A and B assets declined to a point where the Bank realized that it would have to collect upon the *guaranty*. Accordingly in March, 1932, the North Carolina Bank called upon taxpayer to make a *final settlement* of his obligations under the *guaranty* (R. 15).

6. The taxpayer thereupon offered to make a final settlement and pay his obligations under the guaranty by giving the Bank his note for $250,000, and assigning to the Bank certain securities which the Bank held. The Bank *accepted the taxpayer's offer*, and upon receipt of the taxpayer's note and the assignment of the securities which it already held, considered that the *guaranty obligations were fully discharged*, and accordingly delivered to taxpayer the two notes which had been executed under the guaranty agreement and marked them paid. Both the taxpayer and the Bank considered this to be *final payment* and settlement of taxpayer's *obligations under the guaranty*. (R. 15.)

7. In December, 1932, the taxpayer advised the North Carolina Bank & Trust Company that he desired to withdraw the securities of his wife and to deposit a like amount of his own securities. This request was granted and in that month taxpayer assigned to the Bank the same amount of Jefferson-Standard stock which he owned.

8. The taxpayer claimed a loss on the transaction in his return for 1932 in the amount of $125,000, being his own half of the guaranty for which he had no possibility of reimbursement. He did not claim a loss on Gold's half of the guaranty in 1932 because he still had a claim against Gold's Estate for reimbursement. In his return for 1933 taxpayer claimed a loss for the remaining half, representing Mr. Gold's part of the guaranty, when it was ascertained that Gold's Estate was insolvent in 1933. (R. 16.)

9. The Commissioner allowed the loss claimed for 1933, when it first appeared that Gold's Estate was insolvent and that taxpayer would receive no reimbursement for the loss sustained on that part of the guaranty. He disallowed the loss claimed for 1932 upon the ground that the taxpayer had not paid cash in that year. But the loss for both years arose out of precisely the same transaction. (R. 35.)

Summary of Argument.

The Commissioner bases his argument in the final analysis almost wholly upon the decision of this Court in *Eckert v. Burnet* (1931), 283 U. S. 140. We desire, therefore, first to point out in this brief three things in connection with that case, as follows:

Point 1—That Eckert v. Burnet, arose out of an entirely different state of facts, and is distinguishable upon its facts.

Point 2—That Eckert v. Burnet, did not involve the same issue of law as was involved in the instant case.

Point 3—That even if the rule in Eckert v. Burnet, is applied to this case the taxpayer is still entitled to the deduction in question.

ARGUMENT.

The Commissioner in effect concedes on brief that the taxpayer suffered the loss in question, and that if the taxpayer has been on the accrual basis, "the deduction here claimed would be allowable in 1932". (Br. pp. 9-10). The only question raised by the Commissioner is *when* the loss is deductible.[1] The Commissioner contends that the loss was not deductible in 1932 because the loss was not paid in cash during that year. The Commissioner cites *Eckert v. Burnet* as the only authority from this Court on the subject.

POINT 1.

Eckert v. Burnet arose out of an entirely different state of facts, and is distinguishable upon its facts from the case at bar.

(1) In the first place, in *Eckert v. Burnet* there was no agreement whatever between Eckert and the bank that Eckert's note should be accepted by the bank in settlement and final payment of the Corporation's note. Eckert simply renewed or extended an already existing obligation with no understanding that it was a payment of any sort. As Judge L. Hand said of the *Eckert case* in *Shiman v. Commissioner*, 60 F. (2d) 65: "When called upon to *pay* he gave his note *instead*." (Emphasis supplied.)

In the instant case it was expressly agreed between Mr. Price and the North Carolina Bank and Trust Company

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[1] In a footnote the Commissioner suggests some speculation about the loss in question being treated possibly as a "capital outlay". That speculation is quite inconsistent with the Commissioner's statement found on p. 10 that "Had Respondent used the accrual system then clearly the deduction here claimed would be allowable in 1932, for on the accrual basis pecuniary obligations • • • are treated as discharged when incurred." Surely the fact as to a loss occurring would be the same on either basis—regardless of its deductibility.

that the note and securities given by Mr. Price should be accepted "in final settlement" and "as a final payment" of his obligations under the guaranty. (R. 15.)

(2) In the second place, in *Eckert v. Burnet*, Mr. Eckert's original obligation was simply that of an endorser upon a note. His liability upon that note was a limited one restricted by the terms of the note and by the conditions as to due presentment for payment at maturity, notice, demand and protest, and subject to all the various principles governing the relationship of accommodation endorsers under the law of negotiable instruments. If the bank had omitted or failed to comply with any of the technical requirements as to such endorsements, Eckert as endorser might have been ultimately relieved of his liability on said note or any extension thereof.

But in the instant case Mr. Price's obligations were incurred through a contract of indemnity under which he incurred certain contingent liabilities and acquired certain contingent assets. When those assets became worthless he was called upon not to *renew* his liability, but to *pay* it. And he did *pay* it.

(3) In the third place, in the *Eckert case* there was no assignment or transfer of securities or other property by Eckert to the bank.

But in the instant case Mr. Price assigned and transferred securities to the Bank admitted by the Commissioner to be worth in excess of $250,000 (R. 8), and which securities Mr. Price could never recover without giving up other property of equal value therefor.

Mr. Price's economic loss occurred when he parted with those securities in 1932 as part of the terms and conditions of his payment. It was *then* that his estate was diminished —*not* in a later year when he merely exchanges one asset for another by giving cash *in consideration for the return* of the securities.

(4) In the fourth place, in the *Eckert case* there was no other property to which Eckert could look for reimbursement.

But in the instant case there were valuable assets, known as the Class B assets, in which Mr. Price had an interest and to which he could look for reimbursement of any loss he was compelled to pay under his guaranty. Those assets also became worthless in 1932.

POINT 2.

Eckert v. Burnet did not involve the same issues of law as are involved in the instant case.

(1) The real issue before the Court in *Eckert v. Burnet* arose out of Eckert's claim that he could deduct the old note of the Electric Refrigerator Company as a *bad debt*. As Justice Holmes stated in that case (p. 140): "The petitioner claimed a deduction from income of $22,400 as a bad debt." And again on page 141, "The petitioner claims the right to deduct that sum as a *debt* 'ascertained to be worthless and charged off within the taxable year.'" (Emphasis supplied.)

That was the issue upon which Justice Holmes decided *Eckert v. Burnet*. Said Justice Holmes (p. 141):

"It seems to us that the circuit court of appeals sufficiently answered this contention by remarking that the *debt was worthless when acquired.* There was nothing to charge off. The *petitioner treats the case as one of an investment that later turns out to be bad.*" (Emphasis supplied.)

In other words, *Eckert v. Burnet* decided an issue of a *bad debt* under Sec. 214(a)(7), Revenue Act of 1926. It did not decide an issue of a loss under Sec. *214(5)*. Sec. *214(5)* (the loss provision) was not before this Court in *Eckert v. Burnet*. See Burns Mfg. Co. v. Com., 59 F. (2) 504; Dexter v. Com., 99 F. (2) 769.

What is said in *Eckert v. Burnet* would be pure dictum if it were applied to an issue of loss under Sec. *214(5)*.

The *instant* case involves solely an issue of *loss* under Sec. 23(e), Revenue Act of 1932, which corresponds to Sec. 214(5), the loss section of the 1926 Act.

(2) The issue in *Eckert v. Burnet* when it was tried before the Board of Tax Appeals was whether or not, as a *matter of law*, what the parties did *constituted* payment of the Corporation's note. The Board held that it did not constitute payment because the taxpayer Eckert "merely exchanged his note * * * for the Corporation's notes without any outlay of cash or property having a cash value." There was merely an extension of the old obligation with no agreement between the parties that what was done should constitute payment. The stamping of the note by the Bank as "PAID" did not of course prove payment by Eckert. It is common practice in most banks to stamp renewed notes as "PAID."

That is not the issue in the present case, where *payment* has been found as a fact.

POINT 3.

But even if Eckert v. Burnet is to be considered as correctly stating the rule as to the deduction of losses, the taxpayer here complied with that rule in all respects, and is entitled to deduct his loss.

(1) The rule as stated in *Eckert v. Burnet* establishes *Payment* as the test of deductibility. The language of *Eckert v. Burnet* makes it perfectly clear that Eckert would be entitled to deduct the bad debt "if the petitioner ultimately *pays* his note." (Emphasis supplied.) (283 U. S., p. 142.)

(2) The rule that *payment* by the taxpayer of the obligation in question is the best test of its deductibility has been followed in numerous cases:

United States v. Collier, (C. C. A. 5), 104 F. (2d) 420.
Bailey v. Commissioner, (5th Cir.) 103 F. (2d) 448.
Mellinger v. United States, (Ct. Cl.), 21 F. Supp. 964.
Humphrey v. Commissioner, 91 F. (2d) 155.
Schlemmer v. United States, 94 F. (2d) 77.
Insurance Finance Co. v. Commissioner, 84 F. (2d) 382.
Landers Bros. v. Commissioner, 60 F. (2d) 85.
Shiman v. Commissioner, 60 F. (2d) 65.
Jarvis v. Heiner, 39 F. (2d) 361.
A. D. Weiss, 13 B. T. A. 1284.

(3) Payment has been recognized as the best test of deductibility by the outstanding tax authorities.

In *Paul & Mertens "Law of Federal Income Taxation,"* the latest and outstanding work on the subject, we find the following:

"* * * the term 'cash method' is a misnomer. It does not mean that only cash receipts are taxable, any more than it means that all cash receipts are taxable. The thought is rather that *both taxable income and items of expenditure need not be in the form of cash.*" (Sec. 10.01.) Citing *46 Harvard Law Review* 933.

"Many of the decisions turn on the question of *security;* they regard as the equivalent of cash obligations which are in some way—by lien, mortgage or otherwise—*secured.* Often this question is valid because relevant to the point of *convertibility into cash.* * * * The real question is whether *cash can be realized;* has the equivalent of cash been received." (Sec. 10.05.) Citing *Bedell v. Commissioner*, 30 F. (2d) 622; *S. L. Meyer*, 23 B. T. A. 1200.

"Bonds, notes and contracts for the payment of money and other property are the equivalent of cash if received on an income producing transaction to the extent of their fair market value * * *." (Sec. 1016.) Citing *Brinkerhoff-Faris Trust Co.*, 14 B. T. A. 801.

"This whole subject of the extent to which notes should be treated as the equivalent of cash is still in a state of uncertainty. The general rule is clear that notes may be treated as the equivalent of cash; * * *." (Sec. 10.16.) Citing *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U. S. 462. (Emphasis supplied.)

In *Holmes "Federal Taxes,"* sec. 471, the principle is stated as follows:

"It is not necessary that an amount claimed as a deduction be paid out in cash. Just as income may be received in kind or in the equivalent of cash, so *deductions may be represented by payments in some form other than cash*." (Emphasis supplied.)

Roswell Magill, former Undersecretary of the Treasury, in an article in the *Harvard Law Review*, Vol. 46, p. 936, states the principle as follows:

"A concession is necessary at the outset because the bulk of claims are not actually liquidated in cash; salaries, dividends, rent, interest, etc., are commonly paid by check. * * * *Negotiable notes have been treated as cash to the extent of their fair market value*, but a non-negotiable note has been regarded as giving rise to income only as collected." Citing *Lyle v. Olson*, 24 B. T. A. 702; *A. W. Wolfson*, 1 B. T. A. 538; *Potter Farms, Inc.*, 6 B. T. A. 110; *C. W. Slater*, 5 B. T. A. 804; *Mainard E. Crosby*, 14 B. T. A. 980. (Emphasis supplied.)

(4) The Commissioner's own regulations have for *twenty years* recognized this principle. Ever since the promulgation of Regulations 45 under the Revenue Act of 1918 and continuing through the successive regulations promulgated under the revenue acts ever since, the Commissioner has ruled as follows:

"Items of *income* and of *expenditure* which as gross income and *deductions* are elements in the computation of net income, *need not be in the form of cash*. It is sufficient that such items, if otherwise properly included in computation, *can be valued in terms of money*." (Art. 321 *Regs.* 77.) (Emphasis supplied.)

That rule has been recognized by the Bureau in several rulings and indeed insisted upon by the Bureau in numerous cases.

A. R. R. 113, C. B. 2, p. 114.
O. D. 741, C. B. 3, p. 115.
A. R. R. 479, C. B. 5, 146.
I. T. 1182, C. B. I-1, p. 142.
I. T. 1167, C. B. I-1, p. 149.
I. T. 1697, C. B. II-1, p. 95.

In *A. R. R. 479, supra*, the Bureau very clearly indicated that if a pre-existing obligation is *actually paid* by the acceptance of notes in extinguishment of the old obligation, such a payment would be an allowable deduction. The loss was disallowed there expressly because the taxpayer "simply renewed the old notes" and because "it appears clear that A has never become *primarily* liable for payment of the principal of said notes."

In the following cases the Bureau insisted upon the rule that payment is the test of deductibility:

Crain v. Commissioner, 75 F. (2d) 962.
Darling v. Commissioner, 49 F. (2d) 111.
Avery v. Commissioner, 22 F. (2d) 6.
Yoder v. Nauts, 34 F. (2d) 450.

(5) *Payment* of taxpayer's obligations upon his guaranty to the Bank was not only *found as a fact* by the Board of Tax Appeals, but was also conceded by the Commissioner and stipulated as a fact. (Dep. Clark, p. 73.)

Hence the issue of whether the guaranty was *paid* or not, is not an issue in the case. *Payment* was found as a

fact. Hence it could never have been an *issue of law* in this case.

The Board of Tax Appeals admitted all this in its opinion. The Commissioner conceded *before this Court* in his petition for certiorari that Mr. Price's note and securities were *accepted* by the North Carolina Bank and Trust Company "*in* final *settlement*" of Price's prior obligations upon his guaranty of the assets of the Atlantic Bank, and that: "Both the taxpayer and the Bank considered this to be a *final payment* of the two notes given under the guaranty." (Emphasis supplied) (Pet. for Cert. p. 6) (R. 15.)

* * * * *

(6) But, argues the Commissioner, Mr. Price's payment was not made *in cash*—therefore his loss is not deductible.

(a) The Commissioner's contention stultifies and nullifies his own regulations which have held for twenty years that such payments "need not be in the form of cash", but may be in the form of any property which "can be valued in terms of money". Art. 321, *Regulations 77* and *74;* Art. 22, *Regulations 69, 64, 62* and *45.*

This Regulation, Art. 321, *supra,* was issued under the general provisions as to the method of reporting income and deductions by *all* taxpayers, and necessarily applies to taxpayers on the cash basis of accounting.

In addition to this, however, the Commissioner's contention is squarely in conflict with the Commissioner's regulations as to the general doctrine of deductions of losses

which is found in Art. 23 (e) (1), *Regulations 86*, where it is said:

> "In general losses for which an amount may be deducted from gross income must be evidenced by *closed and completed transactions*, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed." (Emphasis supplied.)

The Board has found as a fact that in March, 1932, both the taxpayer's and Gold's obligations under the guaranty contract were *paid and discharged* by the acceptance by the North Carolina Bank & Trust Company of taxpayer's note for $250,000 and the securities assigned therewith, and that there was *no hope of recoupment* from the Class B assets. As the Board said: "Both petitioner and the Bank considered this to be a *final payment* of the two notes given under the guaranty." (Emphasis supplied.)

In other words, when the taxpayer paid his own and Mr. Gold's obligations under the guaranty and taxpayer's right of recoupment from the Class B assets became worthless in 1932, the whole guaranty transaction was definitely and finally ended. The Board finds this as a fact, and the Commissioner virtually admitted as much before the Board.

Did that constitute a closed and completed transaction? If so, then the taxpayer is entitled to deduct the loss since it would come squarely within the Commissioner's own regulations. The cases are practically uniform that *payment* of a pre-existing obligation such as a guaranty or contingent liability effectually and finally *discharges* that obligation, and any rights arising thereafter spring from a new undertaking and not from the old undertaking. This

has been recognized in the law of income taxation from the very earliest cases, as well as at general law. The question has always been—was the old undertaking *paid and discharged?*

In short, the legal purpose and effect of the *Payment* of a pre-existing obligation for tax purposes is to establish the fact that the *old obligation* has become a *closed and completed transaction;* and under the express provisions of the Commissioner's own regulations, in Art. 23 (e) above, the loss arising out of that transaction is a deductible one.

* * * * *

(b) The Commissioner's contention that the payment of a loss has to be made in cash, is in conflict with numerous tax cases decided by the Federal courts and the Board of Tax Appeals. These courts have considered the question from the economic as well as the legal aspects of the matter and have refused to be bound by the narrow concept that the payment of an obligation must be made in cash.

One of the best statements of that principle is found in *Schlemmer v. United States,* 94 F. (2d) 77, where the Second Circuit, speaking through Judge Learned Hand, said:

> "The plaintiff's note did not pay the company's debt, *unless the parties agreed that it should.* Peter v. Beverly, 10 Pet. 532, 568, 9 L. Ed. 522; Lyman v. Bank of United States, 12 How. 225, 243, 13 L. Ed. 965; The Emily Souder, 17 Wall. 666, 670, 21 L. Ed. 683; Segrist v. Crabtree, 131 U. S. 287, 9 S. Ct. 687, 33 L. Ed. 125. The defendant asserts that they had so agreed because of the tax returns; but that is not so.

Those did indeed presuppose that the note was a proper entry in a cash return, but that does not show that the parties had agreed that it should be payment; they may have supposed that a note so taken always pays the debt; or that it must be treated as cash whether it was payment or not. They were laymen, and we can tell nothing about what facts they took for true in reaching the conclusion that the note was cash. The only actual testimony was that the note was *not taken as payment*, but only as more permanent evidence of the debt. Indeed, it is not at all clear that it would have been a cash item, even if it had in fact been taken as payment. It did not change the substance of the debt—*not being endorsed or secured*—and although it was more readily disposable, *that single incident was scarcely enough.* There must be more than difference in the mere form of property to justify a charge of income. Weiss v. Stearn, 265 U. S. 242, 44 S. Ct. 490, 68 L. Ed. 1001, 33 A. L. R. 520. But we need not stand on that; in any case *since it was not taken as payment, it could not be treated as cash; the old debt remained, the note was no more than added security.*" Sass v. Commissioner, 12 B. T. A. 156 (semble); Merren v. Commissioner, 18 B. T. A. 156; Humphrey v. Commissioner, 32 B. T. A. 280. (Emphasis supplied.)

The Court of Claims has recognized the rule more than once. In *George J. Mellinger v. United States*, 21 F. Supp. 964, that Court said:

"If nothing had been done except to take new notes it would hardly be contended that there was a payment and that the new notes were evidence of income received. The rule in most jurisdictions, including the federal courts, is that *in the absence of agreement or*

consent to receive it as such, a promissory note of the debtor, although accepted by the creditor, does not in itself constitute payment or amount to a discharge of the debt. 48 C. J., p. 610, sec. 40. And the Board of Tax Appeals in *San Jacinto Life Ins. Co.*, 34 B. T. A. 186, held that a promissory note given in evidence of the liability of the maker for overdue interest upon which nothing was paid did not show that the taxpayer received any interest income. The evidence fails to show that there was *any agreement or understanding between the debtor and creditor that the new notes should operate as a payment and extinguish the original indebtedness.*" (Emphasis supplied.)

This principle has been recognized by the Federal courts as applied both to questions of income and questions of deductions from income. See *Humphrey v. Commissioner*, 91 F. (2d) 155 (9th Cir.); *Jenkins v. Smith*, 21 F. Supp. 433, affirmed 99 F. (2d) 827 (2nd Cir.); *Bedell v. Commissioner*, 30 F. (2d) 622 (2nd Cir.).

* * * * *

(c) The Commissioner's contention that the payment of a loss has to be made in cash, ignores the essence of the very rule laid down by this Court in *Eckert v. Burnet*—that losses are deductible whenever the taxpayer "makes an outlay of cash or *property having a cash value*". (Emphasis supplied.) (283 U. S., p. 141.)

It is interesting to note that this Court in stating the rule above, actually quoted the words of the Board of Tax Appeals, which has always adhered to the principle that a payment for purposes either of income or deduction need not be in cash. In fact the Board has held in many other cases

that the true test of the deduction is not necessarily the payment of cash, but is whether or not the payment in question represented a *closed and completed transaction.* See *Wilford C. Saeger*, 9 B. T. A. 890, 898; *Ewing Thomas Converting Co. v. McCaughan*, 43 F. (2d) 503; *Thatcher & Son*, 30 B. T. A. 510; *Consolidated Tea Co. v. Bowers*, 19 F. (2d) 382.

* * * * *

(d) The Commissioner's contention that the payment of a loss has to be made in cash is in conflict with the decisions of this Court and the courts of the several States, which hold that for any purpose, legal or equitable, payment of an obligation can be made in any form of property which the parties agree upon. These decisions hold without exception that a pre-existing obligation can be paid by the giving of cash, notes, checks, property or anything of value which is accepted by the creditor as payment; and that such payment discharges the prior obligation and deprives the creditor of any further action or remedy thereon.

This Court as early as *Segrist v. Crabtree*, 131 U. S. 287, 33 L. ed. 125, said:

> "One of the principal questions arising upon the evidence was whether two notes, payable respectively in September, 1881, and September, 1882, were received in *actual payment* (in which event the *remedy is upon the notes*), or only as evidence of the amount to be paid by Crabtree. In *Sheehy v. Mandeville*, 10 U. S. 6 Cranch, 253, 264 (3:215, 219, *Chief Justice* Marshall said: 'That a note, *without a special contract*, would not, of itself, discharge the original cause of action, is not denied. But it is insisted that if, by express agreement, the note *is received as payment*, it satisfies the original contract, and the party receiving it must take

his remedy on it. *This principle appears to be well settled.* * * * Since, then, the plaintiff has not taken issue on the averment that the note was given and received in discharge of the account, but has demurred to the plea, that fact is admitted, and, being admitted it *bars the action for the goods!*" (Emphasis supplied.)

The Supreme Court of Iowa in the recent case of *State v. Chambers*, 179 Iowa 436, 161 N. W. 470, states the rule as follows:

"When the parties agree to treat something other than money as constituting payment, the law will so treat it."

In *Roberts v. Vonnegut*, 58 Ind. App. 142, 104 N. E. 321, the highest court of Indiana said:

"Anything is payment which the one obligated offers as payment, and the one to whom payment is due accepts as payment."

The general rule prevalent throughout the State courts is stated in 21 *R. C. L., Payment*, Sec. 45, page 47, as follows:

"In the absence of statutory restrictions the parties to an agreement at the time of entering into or at any other time may waive payment in money, and the promisee may agree to accept in payment notes, checks, drafts, or any other thing of value. In other words, the parties to a contract may agree as to the medium of payment and their contract will be enforced." (Citing cases from all jurisdictions.)

And in the same article, Sec. 72, page 72, it is said:

"If there is an express agreement by the creditor to receive a note as absolute payment and to run the risk

of its being paid, it will be held to be an extinguishment or payment of the precedent debt, whether *the note is afterwards paid or not;* but a clear agreement or manifestation of intention of both the parties to that effect is essential." (Emphasis supplied.)

There seems to be no doubt whatever but that the giving of a note may constitute payment of an antecedent obligation of any sort. *Clarendon County v. Curtis,* 46 F. (2d) 888; *In Re Dixon,* 13 Fed. 109. Whether or not the giving of a note to cover an antecedent obligation constitutes payment and discharge thereof depends solely upon the intention of the parties, *i. e.*, whether the old obligation is merely renewed, or a new obligation differing in its terms is created. *Horne v. Young,* 40 Ga. 193; *Dewey v. Bell,* 5 Allen (Mass.) 165; *Squires v. Adams,* 70 Ill. App. 502.

In North Carolina where this taxpayer lives, the authorities are absolutely uniform that where a note is given merely in renewal of a prior note or obligation, the giving of the second note does not extinguish the original debt nor in any way change the debt, except to extend the time of payment—*but if the second note is given and accepted in payment of the old debt and not merely in renewal thereof, an entirely different principle applies and the old obligation is extinguished for all purposes.*

Smith v. Bynum, 92 N. C. 108.
Terry v. Robins, 128 N. C. 140.
Bank v. Hall, 174 N. C. 479.
Kilpatrick v. Kilpatrick, 187 N. C. 523.
Dyer v. Bray, 208 N. C. 248.

* * * * *

(e) The Commissioner's contention that the payment of a loss has to be made in cash fails to take into account

the *legal effect* of what took place. In reality the transaction constituted a payment of taxpayer's admitted loss with borrowed funds.

The Court below said this:

> "The facts of the case, in final analysis, amount to a borrowing by taxpayer from the Bank of funds with which to meet the liability on his guaranty and the application of the proceeds of the loan to that purpose; and we know of no principle of law or of justice which would deny him the right to deduct the loss arising from his guaranty until that loan is repaid."

The facts of record fully support that conclusion of the Court below. The taxpayer, Mr. Price, from numerous conferences with the Bank, knew that the Bank needed the cash and that his note could be discounted immediately for cash by the Bank. The very fact that his note was as good as cash and could be immediately discounted for cash, was one of the reasons, of course, why the Bank was willing to accept Mr. Price's note and securities as payment of the guaranty.

The Federal courts have held in numerous tax cases and the Commissioner has conceded in those cases that, if the taxpayer had borrowed funds from another bank across the street on exactly the same note as the taxpayer gave the North Carolina Bank, undoubtedly he would have been entitled to deduct the loss in 1932. Such is the holding in *Crain, Executors, et al. v. Commissioner*, 75 F. (2d) 962, which decision the Commissioner published as having the effect of a Bureau Ruling in C. B. XIV-2, p. 281. To the same effect are *Jenkins, et al. v. Smith*, 21 F. Supp. 433; *Jarvis v. Heiner*, 39 F. (2d) 361; *Humphrey v. Commis-*

sioner, 91 F. (2d) 155; *Weis v. Commissioner*, 13 B. T. A. 1284.

The *Crain case, supra*, is important because the facts in that case, in the essential particulars, are similar to the facts in the case at bar. In that case the taxpayer took the same position that the Commissioner takes in the instant case. The Court held that the taxpayer was wrong and the Commissioner was right. In the *Crain case* it was conceded that taxpayer was on the *cash receipts and disbursements basis*. He with one Wesson was jointly liable on the assumed obligations of the debts of the National Car Advertising Co. It was evident in 1913 that there would be a loss for which they would ultimately be liable. The essential facts are best expressed by the Court in its opinion as follows:

> But in the year 1916, the amount of the *loss became definitely certain*, and the whole of it was actually paid by Wesson. Since the taxpayer did not himself have on hand enough cash to pay his half, he agreed with Wesson that the latter should *advance all of the money in payment of the loss*, and the *taxpayer would make to Wesson a note for the taxpayer's half of such loss.*
>
> "*In fair effect, what the taxpayer did in 1916 was to borrow $40,000* in money with which to pay the loss, now here in dispute, as to the date of its accrual for taxing purposes. It seems clear, from the facts here and the ruled cases, that the loss occurred in 1916. Avery *v.* Commissioner (C. C. A.), 22 F. (2d) 6, 55 A. L. R. 1277; Darling *v.* Commissioner (C. C. A.), 49 F. (2d) 111. Did the giving of the note to Wesson have the effect to lawfully postpone deduction of the loss from income till the year in which the note was paid?

"The taxpayer contends that it did, and, so contending, relies largely on the case of Eckert *v.* Commissioner, 283 U. S. 140, 51 S. Ct. 373, 374, 75 L. Ed. 911, as decisive in his favor. * * * " (Emphasis supplied.)

The Court in this opinion distinguishes the *Crain case* from the *Eckert case* and holds that the deductible loss occurred in 1916. The Court then says:

"Moreover, counsel agree, and the decisions of the Board of Tax Appeals sustain their agreement, that the fact that *a loss is paid in borrowed money does not have the effect to change the date at which the loss was sustained from the year of the loss to the year in which the borrowed money was repaid.*

* * * * *

"To the same effect are the cases of Weis *v.* Commissioner, 13 B. T. A. 1284; Crawford *v.* Commissioner, 11 B. T. A. 1299; and Perry *v.* Commissioner, 28 B. T. A. 497." (Emphasis supplied.)

In fair effect, as decided by the Court below, what Mr. Price did was to borrow funds from the North Carolina Bank and Trust Company to pay to it his loss under the guaranty, which was first definitely ascertained in March, 1932, to be $250,000. Paying the loss under the guaranty as he did, by giving his fully secured note to the North Carolina Bank & Trust Company, left him in reality in exactly the same situation as if he had made the fully secured note in question to another bank and had used the proceeds to pay his loss under the guaranty to the North Carolina Bank & Trust Company. The Government concedes if Mr. Price had given said note to another bank and used the proceeds to pay the loss under the guaranty, he would have had a loss for tax purposes and would be entitled to the de-

duction claimed. The reality of the situation is that the loss of the taxpayer is just as genuine and the payment to the bank of the loss under the guaranty just as complete, as if Mr. Price had borrowed from another bank. The fact that the borrowing was from the same bank to which the loss under the guaranty was paid, can make no real difference. It is utterly immaterial where the taxpayer borrowed the funds if the result thereof resulted, as in this case, in the payment of his admitted loss. That there was payment by the taxpayer of his loss is not open to question, since the Board of Tax Appeals has found as a fact that the taxpayer did make payment.

As recently stated by this Court in *Helvering v. Lazarus* (December 4, 1939): "In the field of taxation administrators of the laws and the courts are concerned with substance and realities." Just so, the form of the transaction in the instant case is unimportant since what really happened was a payment by the taxpayer of his loss under the guaranty with funds which happened to be borrowed from the same bank upon the taxpayer's fully secured note. The point is that Mr. Price was not renewing a note; he was paying an established loss under a guaranty, in effect, with funds borrowed on his own secured note.

The case of *Jenkins et al. v. Smith*, 21 F. Supp. 433, affirmed 99 F. (2d) 827, is closely analogous on the facts to the instant case. In that case the taxpayer, in order to protect his investment in the stock of a bank in which he was a director, made a guaranty agreement together with other directors, and deposited certain collateral. In the following year, 1933, the bank ceased doing business and called upon the guarantors for payment under their guaranty. The taxpayer thereupon arranged to borrow *from the same bank*

the same amount of money for which he was liable, giving to the bank his own promissory note. In that way the taxpayer claimed a loss in his return for 1933. Said the Court:

"The deduction was proper and plaintiffs must prevail if, under all the circumstances, *the obligation on the bond was paid.* The defendant urges, however, that there was no payment in fact, but only in form, since the decedent remained obligated to the First National Bank and Trust Company for the same amount, evidenced by a new note. He parted with no cash in 1933, but merely borrowed from his payee in order to pay the same payee.

"In my opinion, *the obligation on the bond* was discharged by the acceptance by the First National of the check as payment. *Where or how the decedent obtained the money with which to make the check good is immaterial.* The acceptance of the check as payment discharged the obligation even though it created an overdraft. A new cause of action arose upon the check. The First National could no longer have sued the decedent on the bond. The bank knew of the overdraft, but was satisfied to take its chances on the new obligation. *The bond transaction was closed.*

"The credit to the decedent's account, made on the same day, was the result of a new transaction, initiated by a promissory note to the bank secured by new collateral. It was in no sense an extension of time for payment of the old debt. It was *a new contract of a substantially different nature.*" (Emphasis supplied.)

One of the best statements of the principle is found in *A. D. Weis*, 13 B. T. A. 1284. In that case taxpayer entered with one Morgan into a business venture, the capital for which was furnished by the taxpayer. Part of such capital

was out of taxpayer's own funds and part was money borrowed by him from a bank. The business was unincorporated. It was understood between taxpayer and Morgan that taxpayer would be responsible for the finances of the venture. The venture borrowed money from the bank during the first part of 1919 in the amount of $9,000, and notes were executed in the name of the venture. The venture proved a failure in the latter part of the same year. Morgan was without resources. The bank pressed for payment of the note executed by the venture, and taxpayer gave his own note to the bank in the amount of the principal plus accrued interest. This note was not paid by the taxpayer until 1923. The taxpayer claimed a deduction, however, as a loss for 1919. The Board sustained the taxpayer's claim and said:

> "We are of the opinion that all the losses here in question were sustained in the years in which the several investments became worthless. In such respective years each of the deals became a closed transaction and the petitioner's net assets were reduced in the amount of the loss sustained. *It is not material whether such losses were met by the payment of cash from funds in hand or with cash borrowed from the bank and evidenced by notes payable in a subsequent year.* The loss had been sustained and the transaction had been closed by a cash payment. *The use of the petitioner's credit to secure funds from the bank was a new and different deal and had no more to do with the petitioner's tax liability than any other borrowing that he did in the taxable year.* Cf. *Bob H. McGinnis*, 4 B. T. A. 209." (Emphasis supplied.)

In the case of *John C. Hermann*, 27 B. T. A. 409, the same rule is followed. In that case taxpayer borrowed a

sum of money from an insurance company in 1919. In 1928, the year in question, he was indebted to the insurance company for the original loan plus accrued interest, totalling $5,293. In that year he accordingly borrowed $8,725 from the insurance company, from which amount the company deducted the old loan and accrued interest, and paid to taxpayer the net difference. The taxpayer claimed the amount paid as a deduction in 1928. The Board sustained the taxpayer, saying:

> "We have consistently held that the borrowing of money with which to pay deductible business expenses does not postpone credit for the payment to the year of repayment of the loans. *Ida Wolff Schick*, 22 B. T. A. 1067; *Robert B. Kennan*, 20 B. T. A. 498. The fact that the full amount of the second loan was not handed to this petitioner in cash and the sum necessary to cover the first loan and interest handed back is of no importance. It was applied in satisfaction of petitioner's indebtedness and so was constructively received and disbursed by him. *United States v. Boston & Maine R. R. Co.*, 279 U. S. 732; *Henry D. Muller*, 16 B. T. A. 1015; *Mrs. Frank Andrews*, 26 B. T. A. 642."

While certain portions of the *Hermann* opinion have been modified in a later decision of the Board in *S. E. Thomason*, 33 B. T. A. 576, that part of the opinion quoted above has not been modified and remains a correct statement of the law.

In the case of *Keenan v. Commissioner*, 20 B. T. A. 498, the Board adhered to the same principle and said:

> "That the payments were made with borrowed money is not material and can not have the effect of

postponing the deductions until the years in which the borrowed money was repaid. To hold otherwise would in effect permit taxpayers to elect the years in which expenses might be deducted from income."

Under the theory of the Board's decision in this case Mr. Price, the taxpayer, was not entitled to deduct the loss in 1932, and can not deduct the loss until he pays the $250,000 note which he executed in 1932. Under that theory Mr. Price could wait until 1940 or even later if he chooses, and take a deduction for a loss which all the facts show was actually fixed and determined and was economically suffered by the taxpayer in 1932.

Or, if Mr. Price is unable to pay the note at one time, perhaps he may pay a part of it in 1939, a part of it in 1940, and the balance in 1941. If the Board's theory is correct then Mr. Price should be entitled to deduct as a loss in each of those years the amount which he actually pays in each of those years and thus he could spread over three years a deduction which actually occurred ten years previous. That is the logic and the inevitable result if the Board's theory is correct.

The Federal courts, however, have already expressed themselves upon this point in other cases. See *Darling v. Commissioner*, 49 F. (2d) 111; *Avery v. Commissioner*, 22 F. (2d) 6; and *Humphrey v. Commissioner*, 91 F. (2d) 161.

In the very recent case of *United States v. Collier*, 104 F. (2d) 420, the Circuit Court of Appeals, Fifth Circuit, had before it several transactions involving deductions on account of interest and discounts which the taxpayer had constructively paid with borrowed funds. In holding that

payments thus constructively made were deductible, the Court said:

> "We think the judge could conclude that the transaction of loan with the bank was really Collier's throughout, done through the Collier Service Corporation in order to obtain its indorsement and credit with its bank, *and that he was to bear the discount, and did pay it when he entered credit for it on the account he had against the corporation.* We will not overrule this fact conclusion." (Emphasis supplied.)

The Court below recognized the realities of the taxpayer's situation, and held that in fair effect the transaction amounted to a borrowing of credit from the Bank with which to meet taxpayer's admitted liability under the guaranty. Then said the Court:

> "It will not do to say that taxpayer sustained the loss when he paid the debt and not when he incurred it for the purpose of meeting the loss; for one does not sustain a loss by merely paying a debt for which he himself is primarily liable, nor is the loss deferred by contracting a debt with which to pay it. The able attorney representing the Commissioner very properly admitted on the argument that, if taxpayer had obtained the $250,000 to meet the loss *by giving the note to another bank*, he would have been entitled to the deduction claimed; but surely his right to the deduction cannot depend upon the *identity of the bank which extends credit to him.*
>
> * * * * * *
>
> "It is argued that the fact that taxpayer is on the cash receipts and disbursements basis intead of the accrual basis make a difference; but we do not think

so. The question is not one of accruing a loss to occur in the future, but of *dealing with a loss that has already occurred;* and, as heretofore stated, the occurrence of the loss cannot be said to be postponed merely because credit is obtained with which to meet it." (Emphasis supplied.)

* * * * *

(f) The Commissioner's contention that the payment of a loss has to be made in cash, ignores the realities of the situation. In reality the final settlement agreed upon between the taxpayer and the Bank in March, 1932, was a *compromise of taxpayer's liability* under the guaranty. The taxpayer agreed to pay his and Gold's obligations to the Bank "provided they would extend to me certain accommodations", to quote the taxpayer's exact words. These were that the Bank would release him of all further liability under the guaranty, would turn over to him Gold's note for what it was worth, and would not press for payment of the new note. These were all valuable considerations to the taxpayer, especially in 1932 when values were shifting so rapidly and time was of the essence.

It is clear, therefore, that the taxpayer's note for $250,000 executed in 1932 was a new undertaking upon entirely different terms and conditions from either his or Gold's obligations under the guaranty. Mr. Price then assumed an enfirely different obligation from what had previously existed. His liability, previously contingent and uncertain, was now fixed and certain and limited to a definite amount. Taxpayer surrendered certain rights under the guaranty, but he acquired certain rights or claims of the Bank against the Gold estate. In short, there was ample

consideration on both sides for the compromise settlement which took place in 1932.

In other words, in 1932 taxpayer entered into an entirely separate and different relationship with the Bank. At the time he paid his liability in 1932 he ceased to be a guarantor of the Bank and became a debtor of the Bank. When the taxpayer ascertained in 1932 what the losses were in the A assets and that the B assets were likewise worthless, for the first time the relationship of debtor and creditor arose between them. Taxpayer thereupon paid the Bank with the only property he had available, and it was then that his economic loss occurred.

To say that a taxpayer sustains no real or economic loss under a guaranty contract when all the events have occurred which fix his liability and determine its exact amount; when his only source of reimbursement (the Class B assets) has become worthless and the taxpayer has delivered his note to the creditor and has assigned property in excess of his admitted liability—is simply to ignore all the canons of sound business practice and common sense. *Taxpayer has then admitted his liability and he has parted with property worth in excess of the liability.* True, he still has a right to redeem that property some time in the future if he can. But in order to do so he will have to part with other property of equal value, *i. e.*, make a substitution of something else for the securities held by the Bank. *But that substitution, years later perhaps, is not the thing that causes his loss.*

This is best shown by a simple illustration. Suppose Mr. Price had simply delivered to the Bank United States bonds worth $250,000 and the Bank had accepted them in final

payment of his obligation under the guaranty. No one could contend for a moment that the taxpayer had not sustained a deductible loss. Let us go one step further. Suppose Mr. Price had delivered to the Bank United States bonds worth $250,000 and the Bank had accepted them in final payment of his obligation under the guaranty, with a collateral agreement that Mr. Price could repurchase them for cash at any time within two years. Would anyone contend for a moment that Mr. Price had not sustained a deductible loss? We think not. See 48 C J. Payment Sec. 41; Jenkins v. Smith, 21 F. S. 433; Smith v. Young, 11 Bush (Ky.) 393.

But is that not in reality exactly what happened? Mr. Price assigned to the Bank securities worth $250,000 with the understanding that he could reacquire them, or in effect repurchase them, within two years by giving the Bank their equivalent in money. What is the difference in legal effect?

The equity of the taxpayer's position is equally apparent. The Commissioner apparently loses sight of the fact that Mr. Price's financial condition was completely changed by making this payment in March, 1932. Prior to that date his obligations under the guaranty were purely contingent and his securities were delivered to the Bank merely to protect his guaranty. But in March, 1932, his liability was admitted, the amount was fixed and payment was demanded, and the taxpayer reassigned his securities to the Bank as part of the *terms and conditions of payment*. *Prior* to March, 1932, Price could have gotten his securities back without the payment of a dollar, if the Class B assets proved sufficient to protect his guaranty. But *after* March, 1932, Price could *never* get those securities back without giving up cash or other property of equal value.

In other words, in March 1932, Price for the first time parted irrevocably with property worth $250,000, and his estate was diminished accordingly. Such is the holding of the Court below (R. 37) and we submit that is the true test of an economic loss.

There is another equitable aspect of the case that merits consideration. The Commissioner in his regulations has always ruled and in the courts has contended that, whenever a taxpayer on the cash basis accepts a note in payment of a debt, which is the equivalent of cash—such note must be included in the taxpayer's gross income for that year. *Regulations 33*, Art. 4; *A. R. R.* 2895, C. B. II-2, p. 233; *I. T. 1262*, C. B. I-1, p. 71; *A. W. Wolfson*, 1 B. T. A. 538; *C. R. Johnson*, 8 B. T. A. 992; *Magill, 46 Harvard Law Review*, 933.

Under any fair and consistent system of taxation, where the payment of an obligation is held to constitute income to the creditor, the disbursement of that payment is ordinarily deemed to constitute a deduction from the income of the debtor. This Court has recognized the principle that items of income and of deduction under these circumstances are corollaries of each other and in general should be consistently treated. In *Burnet v. Logan*, 283 U. S. 404, this Court said:

> "*Ordinarily*, at least, a taxpayer may not deduct from gross receipts a supposed loss which in fact is represented by his outstanding note. *Eckert v. Commissioner of Internal Revenue*, 83 U. S. 140, *ante*, 911, 51 S. Ct. 373. *And, conversely*, a promise to pay indeterminate sums of money is not necessarily taxable income. (Emphasis supplied.)

The Circuit Court of Appeals, Second Circuit, in *Commissioner v. John Thatcher & Son*, 76 F. (2d) 900, makes it clear items of income and items of deduction under such circumstances are reciprocal and are corollaries of each other. In that case the same court had both sides of the same transaction before it. On the one side the taxpayer, a general contractor, claimed a *loss* under a building contract by reason of the default of certain sub-contractors; on the other side the government contended that the taxpayer's claim for reimbursement from the sub-contractors should be included as *income* to the taxpayer, thereby offsetting any loss. Said the Court:

> "We think the taxpayer's claim for damages against the subcontractors and their sureties was too contingent and uncertain to be treated as compensation by 'insurance or otherwise' for the loss. It is clear from the authorities that the subcontractors and their sureties sustained no deductible loss because of the taxpayer's assertion of a claim which they disputed. *Lucas v. American Code Co.*, 280 U. S. 445, 50 S. Ct. 202, 74 L. Ed. 538, 67 A. L. R. 1010; *Burnet v. Huff*, 288 U. S. 156, 53 S. Ct. 330, 77 L. Ed. 670. *If the liability of the obligor is too contingent to be accrued as a loss* to him, it would seem to follow that the claim of the obligee is likewise *too contingent to be considered compensation* for a loss already realized by the latter. See *Commissioner v. Highway Trailer Co.*, 72 F. (2d) 913 (C. C. A. 7); *Commissioner v. Southeastern Express Co.*, 56 F. (2d) 600 (C. C. A. 5)." (Emphasis supplied.)

The Circuit Court of Appeals, Fourth Circuit, has also expressed this principle that items of income and of deduction under these circumstances are in general to be treated on the same basis. In *Niagara Share Corp. v. Commis-*

sioner, 82 F. (2d) 208, the Court discussed the *Thatcher case*, *supra*, and said:

> "The facts in the case of *Commissioner v. John Thatcher & Son, supra*, are similar to the facts here, except that the taxpayer in the *Thatcher case* made no recovery under its indemnifying bonds and here the taxpayer made only a partial recovery. The principle that should govern both cases is the same and in the *Thatcher case* the court held that the taxpayer was entitled to the deduction and that had the taxpayer succeeded in recovering such recovery would have been income in the year when recovered. *Certainly if the guarantors in the contract involved here had sought to claim a loss under their contract as a deduction in their return for taxation* in any year prior to the year in which, at the end of litigation they were compelled to pay, it would not have been allowed as their liability was too contingent. *This being true, it must follow that any recovery that might be made by the petitioner was too contingent* to defeat the accrual of the loss to it in the year in which the loss occurred." (Emphasis supplied.)

The leading text writers on taxation agree that this is one of the principles which has been followed by our courts under our system of income taxation. In discussing the general principles governing items of income and deduction, *Paul & Mertens*, in sec. 10.01, state this principle as follows:

> "It is sufficient to subject an item to taxability if it is received in the equivalent of cash; by the same token an item of expenditure if otherwise deductible may be allowed as a deduction if paid in the equivalent of cash."

Similarly, under sec. 11.21, it is said:

> *"The corollary of the rule stated in regard to income is true with respect to deductions.* Taxpayers on a cash basis may not take advantage of a liability to pay; they have no right to a deduction until they make payment." (Emphasis supplied.)

The same rule is stated in *Holmes on Federal Taxes*, sec. 471, as follows:

> "It is not necessary that an amount claimed as a deduction be paid out in cash. Just as income may be received in kind or in the equivalent of cash, so *deductions may be represented by payments in some form other than cash.*" (Emphasis supplied.)

The equity of the matter is this. So long as the Commissioner contends and the courts hold that where a secured note having an equivalent cash value is accepted in payment of an obligation and thereby constitutes income to the creditor on the cash basis, conversely and reciprocally the courts should hold that the debtor who has thus parted with the equivalent of cash, is entitled to deduct the payment so made—under any equitable system of taxation.

The Court below has been completely consistent in its decisions on this question. In *Allen v. Commissioner*, (4th Cir.) ... F. (2d) ..., it was held that the receipt of shares of stock in payment for services to be rendered in the future, constituted income when received in 1934, and not in later years when the taxpayer rendered the services and disposed of said stock.

Similarly in *First National Bank, Executors, v. Commissioner*, (6th Cir.), ... F. (2d) ..., it was held that a note

received by the decedent in September 1929, under an agreement with another stockholder of a corporation to induce the decedent to agree to a transaction between that corporation and another corporation, was income to the decedent in 1929, although it was not payable until January 31, 1930.

Other Authorities Relied On By Commissioner.

The Commissioner cites other cases in his brief, but apparently does not rely upon any of them as controlling in this case. The only other cases upon which the Commissioner relies to any extent are *Jenkins v. Bitgood*, 101 F. (2d) 17, and *Ferris v. Commissioner*, 102 F. (2d) 985, a *per curiam* decision.

We have already pointed out in the taxpayer's brief in opposition to this Writ that both of those cases are factually different. A full discussion of those cases and the principles which distinguish them may be found in the taxpayer's brief in opposition to the Writ, pages 11 to 14, and we see no purpose in repeating that discussion here.

POINT 4.

The decision of the Court below has nothing whatever to do with obliterating the distinction between the cash basis and the accrual basis of accounting.

The Commissioner argued in his petition for certiorari that the decision here obliterates the distinction between the cash and accrual basis of accounting. That argument appears inferentially in the Commissioner's brief on certiorari, so we assume that the Commissioner is perhaps relying upon it.

That argument of the Commissioner, however, obviously has no merit. This case was decided by the Court below upon the peculiar and unusual facts which distinguish it from any other case counsel has been able to discover. The decision below is based squarely upon the agreement between Mr. Price and the North Carolina Bank & Trust Company by which Price's obligations (as well as Gold's) under the guaranty were finally compromised and paid. The Court called this the "crucial matter" of the case and quoted in full the finding of the Board of Tax Appeals on that point as the actual basis of its decision. (R. 34.)

The Court below did not evade the principle that Payment is essential to the deduction of a loss by a taxpayer on the cash basis. On the other hand, the Court affirmed that principle in express language (R. 40), and held that the taxpayer Price had met its requirements by actually paying the loss under the guaranty with borrowed funds. Said the Court below:

> "In other words, the taxpayer may not take deduction for a loss where what he has done is merely to postpone the evil day of reckoning. He may take the deduction where he has met the evil day and the loss has been realized. *The fact that he borrows money to meet it is immaterial;* the fact that he borrows to meet an outstanding obligation out of which the loss arises is immaterial; and the fact that he borrows from the person to whom the obligation is due is immaterial, provided that there is, as there was here, *a real payment of such obligation in money or money's worth and not a mere extension or renewal.*" (Emphasis supplied.)

More than that, however, the Commissioner has himself conceded that there was a *payment* by taxpayer of the loss under the guaranty (Brief, pp. 7, 12). Payment was found as a fact by the Board (R. 15). Since payment is the test of deductibility under the cash basis, and since the Court below rests its decision upon the fact that there was a Payment of the guaranty—how can it possibly be contended that the Court's decision "obliterates the distinction between the cash and accrual bases of accounting?". Instead of obliterating the distinction, the Court below actually affirms the distinction by basing its decision squarely on *payment*.

The Alternatives.

Apparently the Commissioner is determined to deny the deductibility of losses in such cases as this regardless of its effect upon the revenue. There are two ways of looking at such cases, and as usual the decision will cut both ways.

If the taxpayer is sustained in his contention, then such losses as this can be sustained in *one taxable year* only, and hence can not possibly be deducted except in that one year. But if the Commissioner's contention is upheld, then, as pointed out by the Court below, the way is open for "taxpayers to spread losses of this character over a number of years by the simple expedient of giving a note or notes in settlement of the loss and claiming a series of deductions as such notes are paid."

It is obviously the purpose of the Revenue Acts to require the reporting of income and to allow the deduction of losses in the taxable period in which those items *reflect* the taxpayer's *correct income*. It seems not only equitable, but also common sense to permit the deduction of a loss in the

period when "the deal became a closed transaction and the taxpayer's *net assets* were reduced in the amount of the loss", to quote the Board of Tax Appeals in *A. D. Weis*, *supra*. The Commissioner concedes that the loss has occurred (Brief p. 9) and that it occurred in 1932 (Brief p. 10), and is only concerned apparently with *when* to allow it (Brief p. 10).

The logical result and indeed the only possible result of the Commissioner's position as stated here is that such losses can be deducted in such cases as and when the notes of the taxpayer are finally paid in cash—years perhaps after the actual loss took place. It leads obviously to a situation where taxpayers can manipulate their taxes by spreading their losses over a period of years, by the simple expedient of giving a note or series of notes and paying them off from year to year, as may be required to offset their income.

Such a procedure certainly would not correctly reflect the taxpayer's financial condition, because his economic loss would occur years before it was reflected in his tax returns. We can not believe that such was the intent of Congress in providing that losses shall be deductible in the year in which they are sustained. See *Rhodes v. Commissioner*, 100 F. (2d) 966, 969.

Such a result was not contemplated by this Court in *Eckert v. Burnet*. As pointed out by Judge Hand in *Shiman v. Commissioner*, 60 F. (2d) 65;

> "We can see no ground therefore for question except some of the language used in Eckert v. Burnet, 283 U. S. 140, 51 S. Ct. 373, 75 L. Ed. 911, taken from our opinion in 42 F. (2d) 158. That was quite another situa-

tion. Eckert, the taxpayer, had been an accommodation endorser for a corporation which became insolvent. When called upon to *pay* he gave his note *instead*, not payable within the year. The court refused to allow the deduction, because Eckert was keeping his books on a cash basis, but it intimated that when he paid he might succeed; until then he had done no more than change the form of the obligation. Yet if it were enough to defeat him that the debt was 'worthless when acquired,' *the same objection ought to be good after he had paid; contrary to what was suggested. We cannot therefore think that the language so thrown out was intended as an authoritative statement by which we must be bound.*" (Emphasis supplied.)

There is another aspect to this matter. The Commissioner's position in this case would lead to equal uncertainty on the income side of similar transactions. In innumerable transactions of this sort the Commissioner has held that a secured note accepted by a creditor in payment of an obligation constitutes income to such creditor on the cash basis, upon the theory that the acceptance of such note in payment is the equivalent of cash and constitutes a closed and completed transaction. If the Commissioner's contention here is sustained upon the ground that Mr. Price's fully secured note was *not the equivalent* of a cash payment—then the only logical basis for holding that such a payment is income to the creditor would also be knocked out of the picture.

In short, it seems rather obvious that from the standpoint of the revenue the Commissioner's contention, if sustained, would open up a veritable Pandora's box of problems.

As we have already pointed out, the Court below based its decision squarely upon the peculiar facts in this case and upon the fair effect which those facts had upon the taxpayer's economic condition. We respectfully submit that the decision of the Court below is sound in fact and in law, and should be upheld.

Respectfully,

D. H. BLAIR,
C. R. WHARTON,
GEORGE D. BRABSON,
Attorneys for Respondent,
Transportation Building,
Washington, D. C.

Of Counsel,
JULIUS C. SMITH,
J. G. KORNER, JR.

SUPREME COURT OF THE UNITED STATES.

No. 559.—October Term, 1939.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* Julian Price. } On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

[March 25, 1940.]

Mr. Chief Justice Hughes delivered the opinion of the Court.

Respondent in his income tax return for 1932 claimed a deduction for a loss upon a contract of guaranty. The Board of Tax Appeals sustained the Commissioner in refusing to allow the deduction, and the Circuit Court of Appeals reversed. 106 F. (2d) 336. Because of an alleged conflict with *Eckert* v. *Burnet*, 283 U. S. 140, *Jenkins* v. *Bidgood*, C. C. A. 2d, 101 F. (2d) 17, and *Ferris* v. *Commissioner*, C. C. A. 2d, 102 F. (2d) 985, we granted certiorari. January 15, 1940.

The facts as found may be thus summarized: In 1929 the Atlantic Bank and Trust Company of Greensboro, North Carolina, was merged with the North Carolina Bank and Trust Company. The latter accepted conditionally certain assets of the Atlantic Bank called "A" assets, and certain other assets, called "B" assets, were pledged to that Bank with authority to charge against them any losses which might be established in realizing upon the "A" assets. Respondent and three other stockholders of the Atlantic Bank executed an agreement of guaranty, to the effect that if the North Carolina Bank failed to realize a certain sum from the "A" assets within two years they would make up the deficiency in an amount not exceeding $500,000. The agreement provided that any sum realized from the "B" assets were to be applied first to any losses occurring in the "A" assets and then to the reimbursement of the four guarantors. The period for realizing upon the "A" assets was extended until September, 1932.

In June, 1931, the North Carolina Bank advised the guarantors that the "B" assets were not in such shape that the Bank could

use them to the extent necessary for banking purposes and requested the guarantors to put their guaranty into a bankable form so that it could be used by the Bank to obtain credit. Respondent accordingly gave to the Bank his note for $125,000 and endorsed the note of C. W. Gold, another guarantor, for a like amount and assigned certain securities to the Bank as collateral for the payment of his guaranty. The Bank agreed that respondent's ultimate liability should not exceed $250,000. At the end of 1931, the guaranty agreement was still in effect. The "B" assets were still in the process of collection. No demand had been made upon respondent. While it was known that there would be some loss to the guarantors, it was not definitely known in 1931 what the loss would be, and the guarantors had reason to believe that there would be a substantial reimbursement from the "B" assets of any losses.

In the early part of 1932, financial conditions being worse, the Bank concluded that it would have to collect upon the guaranty and called upon respondent to make a final settlement of his obligations. Accordingly, in March, 1932, respondent made his note to the Bank for $250,000 and received back the two notes. The Board of Tax Appeals found that both respondent and the Bank considered this to be a final payment of the two notes which had been given under the guaranty. The Bank retained the same collateral for the $250,000 note that it had previously held, and, in December, 1932, respondent substituted therefor certain securities of his own.

Respondent claimed a loss in 1932 in the amount of $125,000, that is, for his one-half of the guaranty. He did not then claim a loss on the other one-half because he still had a claim against the estate of Gold (who had died in 1932) for reimbursement. For that one-half, representing Gold's part of the guaranty, respondent claimed a loss in 1933 and that deduction is not here involved.

Respondent kept his accounts upon a cash basis. The Board of Tax Appeals ruled that respondent was not entitled to the deduction of $125,000 in 1932, upon the ground that "he made no outlay of cash" in the purported payment; he had satisfied his liability as guarantor "by a shifting of the form of his liability". His loss would be deductible "in the year in which he pays the note".

Respondent insists initially that the transaction in 1932 was considered by the parties as constituting a payment of respondent's

liability under the guaranty, and that this payment is a fact found by the Board of Tax Appeals and is not open to review. But the findings of the Board disclose the entire transaction, and its legal effect in the application of Section 23(e) of the Revenue Act of 1932, as to the deduction of losses sustained during the taxable year, was reviewable by the Circuit Court of Appeals. Its decision on that point is reviewable here.

Both the Commissioner and the Board of Tax Appeals relied upon our decision in *Eckert* v. *Burnet*, *supra*. In that case, the taxpayer's return was on the cash basis, and the question was as to a claim of deduction for the year 1925. The taxpayer and his partner were joint endorsers of notes issued by a corporation they had formed. In 1925, in settlement of their liability for an ascertained amount, they made a joint note for the amount due to the bank that held the corporation's paper, "received the old notes, marked paid, and destroyed them". We affirmed the ruling that the deduction should not be allowed.

The court below considered that decision as definite authority only for the holding that a loss of the sort set forth was not deductible under the "bad debt" provision of the statute. That indeed was stated in the opinion as the taxpayer's claim. But the taxpayer had also presented here as an alternative ground the theory of a loss sustained during the taxable year, a ground which the Board of Tax Appeals had considered and held to be untenable. 17 B. T. A. 263, 265, 266. And the Government argued both questions. The Government did not contend that the taxpayer might not at some time be entitled to a deduction "either on account of a bad debt or for a business loss"; the "sole question in dispute was whether he was entitled to the deduction in 1925, the year in which his note was given, or in the later year in which the taxpayer's liability on the note is actually liquidated by payment".

The reasoning of this Court was broad enough to cover both aspects of the case. We said:

"For the purpose of a return upon a cash basis, there was no loss in 1925. As happily stated by the Board of Tax Appeals, the petitioner 'merely exchanged his note under which he was primarily liable for the corporation's notes under which he was secondarily liable, without any outlay of cash or property having a cash value'. A deduction may be permissible in the taxable year in which the petitioner pays cash. The petitioner says that it was

definitely ascertained in 1925 that the petitioner would sustain the losses in question. So it was, if the petitioner ultimately pays his note".

We think that this decision is controlling in the instant case. As the return was on the cash basis, there could be no deduction in the year 1932, unless the substitution of respondent's note in that year constituted a payment in cash or its equivalent. There was no cash payment and under the doctrine of the *Eckert* case the giving of the taxpayer's own note was not the equivalent of cash to entitle the taxpayer to the deduction.

Respondent urges that his note was secured, but the collateral was not payment. It was given to secure respondent's promise to pay, and if that promise to pay was not sufficient to warrant the deduction until the promise was made good by actual payment, the giving of security for performance did not transform the promise into the payment required to constitute a deductible loss in the taxable year. See *Jenkins* v. *Bitgood*, 101 F. (2d) 17, 19.

The judgment of the Circuit Court of Appeals is reversed and the decision of the Board of Tax Appeals is affirmed.

It is so ordered.

Mr. Justice McReynolds took no part in the decision of this case.

A true copy.

Test:

Clerk, Supreme Court, U. S.